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SUMMARY OF MAJOR PROVISIONS OF
SENATE FINANCE COMMITTEE STAFF OPTION
FOR COMPREHENSIVE TAX REFORM

MARCH 13, 1986

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I. INDIVIDUAL INCOME TAX PROVISIONS

A. Rate structure

1. Tax rates would be 15, 25, and 35 percent.

2. The standard deduction would be substantially increased, with an additional amount for elderly individuals.

3. The personal exemption would be increased to $2,000 for itemizers and nonitemizers, and would be phased out between $100,000 and $200,000 of adjusted gross income.

4. The personal exemption, and itemized deductions other than home mortgage interest, real property taxes, and charitable contributions, would be deductible only against the 15-percent and 25-percent brackets.

5. The two-earner deduction and income averaging would be repealed.

6. The earned income credit would be increased (as in the House bill).

B. Personal deductions, exclusions

1. Itemized deductions for State and local sales taxes and personal property taxes would be disallowed.

2. The charitable deduction for nonitemizers would be made permanent (with no floor).

3. The exclusion for scholarships and fellowships would be limited.

C. Business and investment expenses

1. 80 percent of business meal expenses and business entertainment expenses would be deductible.

2. Deductions for travel expenses would be limited for certain educational travel, investment seminars, and luxury water travel.

3. A 1-percent floor would be placed under miscellaneous itemized deductions; certain employee expenses would be deductible only by itemizers.

D. Other items

1. The political contributions tax credit and the Presidential campaign checkoff would be retained without change.

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II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT

A. Depreciation

1. The Accelerated Cost Recovery System ("ACRS") would be retained with the following changes: motor vehicles would be moved to the 5-year class; computers and computer-based telephone central office switching equipment would be moved to the 3-year class; property with an ADR midpoint life of 16 years or greater (other than computer-based telephone central office switching equipment) would be moved to the 10-year class; utility property and steam and electric generators or distribution systems would be included in a 15-year class; and real property would be depreciated using the straight-line method over 30 years. ACRS deductions would be subject to adjustments for inflation between 3 and 8 percent.

B. Expensing

1. Taxpayers would be permitted to expense up to $50,000 of the cost of tangible personal property, subject to a dollar-for-dollar reduction in the $50,000 ceiling for every dollar of investment in tangible personal property that exceeds $200,000 for the taxable year.

C. Investment tax credit

1. The investment tax credit would be repealed.

2. 70 percent of ITC carryforwards in existence as of the termination date would be refunded. A similar rule would apply to ITCs claimed on transitional property.

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III. ACCOUNTING ISSUES

A. Use of the cash method of accounting would be prohibited in the case of corporations (other than "S" corporations), partnerships with a corporate partner, tax shelters, and tax-exempt trusts with unrelated business taxable income. Exceptions would be provided for certain farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less.

B. Use of the installment method would be denied for (1) sales under a revolving credit plan, (2) a portion of sales by dealers in personal property (other than those using revolving credit plans), based on the ratio of the taxpayer's outstanding debt to its adjusted asset basis, and (3) sales of publicly traded property. An exception would be provided for dealer installment sales where resale or rental of the property by the buyer affects the term of the obligation.

C. Taxpayers would be required to capitalize both direct and indirect inventory, construction, and development costs, including interest, under comprehensive uniform capitalization rules. Taxpayers providing property to customers under long-term contracts (those requiring more than 1 year to complete) would be required to capitalize more costs, including interest, in addition to those capitalized under the uniform capitalization rules. A special rule would be provided for certain long-term contracts requiring 2 years or less to complete, if performed by a taxpayer having gross receipts of no more than $10 million.

D. Use of the reserve method of computing deductions for bad debts would no longer be permitted.

E. A simplified dollar value LIFO method of accounting would be provided for taxpayers with average annual gross receipts of $5 million or less.

IV. CAPITAL GAINS

A. The top individual tax rate on long-term capital gains would be 20 percent.

B. The corporate tax rate on long-term capital gains would be 28 percent.

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V. COMPLIANCE

A. Authorization for the payment of attorney's fees in tax cases would be extended.

B. The IRS would be required to pay interest on all tax refunds within 45 days of actual filing of the tax return.

C. A number of areas of tax administration at both the IRS and the Tax Court would be improved.

VI. CORPORATE AND GENERAL BUSINESS TAXATION

A. The top corporate rate would be reduced to 35 percent.

B. The 85-percent dividends deduction for corporations would be reduced to 80 percent.

C. The $100 dividends exclusion for individuals would be repealed.

D. Amounts paid in connection with a redemption of stock (for example, so-called "greenmail" payments) would not be deductible.

E. The rules limiting use of net operating losses after a change of ownership would be altered.

F. Gain would generally be recognized on a distribution or sale of property in liquidation, with certain exceptions. This repeals the so-called General Utilities rule.

G. The rules governing the taxation of certain corporate mergers, acquisitions, and other transactions would be modified.

H. Various rapid amortization elections would be repealed.

I. Federal excise taxes and tariffs would not be deductible for income tax purposes.

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VII. NATURAL RESOURCES

A. Cooperatives would be allowed to net certain losses and gains in determining the amount of patronage income.

B. Capital gains treatment would be disallowed for certain highly erodible land and for wetlands converted to crop production.

C. Prepayments of farming expenses would be restricted for farmers prepaying more than 50 percent of annual expenses, subject to certain exception.

D. Present law would be retained for timber and the domestic production of oil and gas and hard minerals.

E. Solar, wind, geothermal, biomass, and ocean thermal energy credits would be extended at reduced rates.

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VIII. EXCISE AND EMPLOYMENT TAXES

A. The wine excise tax rates would be made equivalent (on an alcohol content basis) to the beer excise tax.

B. The alcohol, tobacco, and motor fuel excise tax rates would be adjusted to reflect price changes.

IX. FINANCIAL INSTITUTIONS

A. Commercial banks would no longer be permitted to use the reserve method of computing deductions for bad debts. Any existing balance in a bad debt reserve account would be recaptured over 5 years or accounted for under the "cut-off" method.

B. Thrift institutions would be permitted to use the experience or percentage of taxable income method of computing a reserve for bad debts only if 60 percent or more of their assets constitute "qualified assets". The percentage of income allowed as a deduction would be 5 percent.

C. All interest expense allocable to a financial institution's holding of tax exempt bonds would be denied, with exceptions for certain types of small issues.

D. Special provisions relating to mergers of financially troubled thrift institutions would be repealed.

E. Net operating losses incurred by financial institutions could be carried back 3 years and forward 15 years, in the same manner as net operating losses of other taxpayers. The 5-year carry forward period originally allowed for net operating losses incurred in years ending after 1980 and before 1986 would be extended to 8 years.

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X. FOREIGN TAX PROVISIONS

A. Passive income would be put in a separate foreign tax credit limitation; income from insurance, shipping, and bona fide active banking would not be considered passive.

B. Interest that incurs a foreign withholding tax of 5 percent or more would be put in a separate foreign tax credit limitation, with a 3-year grandfather for the "Baker 15" countries.

C. Present law rules determining the source of income from sales of inventory property would generally be retained.

D. For transportation income, the House bill provisions would be adopted: 50-50 source rule, and 4-percent gross withholding tax on foreigners.

E. Allocation of interest and other expenses would be required as if all members of an affiliated group were one taxpayer. Foreign borrowings would be taken into account.

F. Certain additional items of passive income earned by controlled foreign corporations would be taxed currently under subpart F. Deferral would be retained for controlled foreign corporations that are engaged in shipping, insurance, or bona fide active banking.

G. For 936 companies, the passive income limitation would be reduced and the required cost sharing payment would be increased.

H. The President's proposal for territorial taxation generally would be adopted; repeal of the V.I. inhabitant rule would apply to all open years.

I. U.S. investors in passive foreign investment companies would be required to pay an interest charge on their deferred income on repatriation.

J. A branch level tax, as modified by the House, would be adopted.

K. An excise tax on insurance premiums paid to foreign insurers would be adopted.

L. Dispositions by foreigners of stock in U.S. corporations would be taxed with exceptions for (1) less than 5 percent holders of publicly traded corporations, and (2) bona fide treaty country residents.

M. Gain on liquidation of U.S. businesses owned by foreigners would be taxed.

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N. A 5-percent withholding tax on portfolio interest paid to foreigners on obligations issued after enactment would be imposed, with treaty overrides for (1) treaty shoppers immediately and (2) all foreign investors after 5 years.

O. Foreign governments would be taxed on business activity, defined to include ownership of controlling interests in U.S. businesses.

P. Importers would be required to take consistent positions on valuation for customs purposes and income tax purposes.

Q. U.S. tax avoidance by foreign owned dual resident companies that use deductions here and abroad would be prevented.

R. The President's proposal concerning foreign currency gains and losses generally would be adopted.

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XI. INSURANCE PRODUCTS AND COMPANIES

A. Life Insurance Products and Companies

1. Present law treatment of inside buildup and policyholder loans with respect to life insurance contracts would be retained.

2. A structured settlement company would be taxed on the investment income on contracts purchased to fund a structured settlement agreement.

3. The special 20-percent life insurance company deduction would be repealed.

4. Present law regarding the tax-exempt status of Blue Cross-Blue Shield, TIAA-CREF, and other similar organizations would be retained.

B. Property and Casualty Insurance Companies

1. 20 percent of the annual increase in unearned premiums would be included in income, as would 20 percent of the outstanding balance of the unearned premium reserve ratably over a specified period.

2. A pretax discounting rule for loss reserves, applicable to each line of business would be adopted at a discount rate initially set at 5 percent.

3. The protection against loss account would be repealed.

4. A single small company provision would be adopted.

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XII. INTEREST EXPENSE

A. Consumer and net investment interest deductions would be limited to a total of $1,000 ($2,000 on joint return) with a 5-year phase-in. Interest on principal and second residences would be excepted.

B. Interest on loans to fund an IRA would not be deductible.

XIII. MINIMUM TAX

A. A minimum tax similar to that in the House bill would be imposed at a 20-percent rate.

B. Charitable contributions of appreciated property would not be a preference.

C. A preference for passive losses would be phased in, and interest on newly acquired tax-exempt bonds would be added as a preference.

D. One half of reported profits not included in the minimum tax base would be a preference. Dealer installment reporting and capital construction funds would be added as preferences.

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XIV. PENSIONS AND EMPLOYEE BENEFITS

A. Pensions

1. Annual elective deferrals of any employee under all cash or deferred arrangements (CODAs) and tax-sheltered annuities would be limited to $7,000. The IRA limit would be reduced by the excess of elective deferrals over $5,000.

2. The special nondiscrimination tests applicable to CODAs would be modified and applied to all employer matching and employee contributions.

3. Tax-exempt and public employers would be permitted to maintain CODAs.

4. Coverage tests, the rules governing the integration with social security, and vesting requirements of qualified plans would be modified.

5. A 15-percent additional income tax would be imposed on withdrawals from a tax-favored retirement arrangement before death, disability, or attainment of age 59-1/2, unless the payments are made in the form of a life annuity.

6. 10-year averaging and capital gains treatment would be replaced with 5-year averaging and capital gains treatment under limited circumstances.

7. Indexing of the dollar limit on annual additions to a defined contribution plan would be delayed until the present-law dollar limit ($30,000) is no more than 25 percent of the dollar limit for defined benefit plans.

8. A 15-percent excise tax would be imposed on aggregate annual distributions from all tax-favored retirement arrangements in excess of specified dollar amounts ($112,500 for 1987).

9. A 10-percent excise tax would be imposed on reversions of surplus assets from terminated plans.

10. The 3-year basis recovery rule would be phased out.

B. Employee benefits

1. Exclusions for educational assistance and group legal services exclusions would be made permanent.

2. Self-employed individuals would be allowed to deduct 50 percent of the amount paid for health insurance.

3. Nondiscrimination tests would be modified by--

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(a) applying nondiscrimination rules to insured health plans,

(b) revising the rules for group-term life insurance, and

(c) establishing a uniform definition of highly compensated employees and excludable employees.

C. ESOPs

1. Present law provisions relating to ESOPs would be retained.

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XV. RESEARCH AND DEVELOPMENT PROVISIONS

A. The R&D credit is made permanent at the present rate, with increased incentives for university basic research.

B. A two-year rule is adopted for allowing the allocation of 75 percent of expenditures against U.S. income.

XVI. REAL ESTATE

A. At-risk rules would be extended to real estate, with an exception for third party nonrecourse debt.

B. A 20-percent credit for certified historic structures; a 10-percent credit would be available for other rehabilitation expenditures.

C. For low-income rental housing, a new credit having a present value of approximately 50 percent of the basis of low-income units would be provided as an elective alternative to tax-exempt bonds. Preferential depreciation and amortization provisions would be repealed.

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XVII. TAX-EXEMPT BONDS

A. Tax-exempt bonds would be continued for direct funding of government operations and for certain other activities under rules similar to present law.

B. Bonds would be IDBs if--

(1) 10 percent or more of bond proceeds were used in a trade or business and payments with respect to the financed property were made to the bond issuer by a private person.

(2) Liberalized rules would be provided for bonds for certain governmental function bonds.

C. Tax-exempt IDB financing would be allowed for--

(1) Multifamily rental housing,

(2) Airports and docks and wharves,

(3) Sewage, solid waste disposal, and water facilities,

(4) Electric and gas local furnishing systems, and

(5) Small-issue bonds and redevelopment bonds.

D. Mortgage revenue bonds would be continued under present-law rules, along with the MCC alternative (subject to an increased trade-in rate), but with no sunset date. Student loan bonds would be continued under present-law rules.

E. Present-law volume caps would be retained; multifamily rental housing and redevelopment bonds would be included under the IDB volume cap. (Section 501(c)(3) organization bonds would not be subject to any volume cap.)

F. The arbitrage rules for all tax-exempt bonds would be changed in several respects, including

(1) Rebate rules like the additional IDB rules (for all bonds other than mortgage revenue bonds),

(2) Restrictions on advance refundings.

G. Information reporting requirements would be extended to all tax-exempt bonds.

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XVIII. TAXATION OF TRUSTS, ESTATES, AND MINOR CHILDREN

A. Unearned income of children under 14 years of age in excess of $5,000 would be taxed to the child at the parent's top marginal rate.

B. The income of a trust generally would be taxed to its grantor if the trust corpus will revert to the grantor or the grantor's spouse.

C. The rate schedule applicable to the retained income of trusts and estates would be compressed compared with present law.

D. The generation-skipping transfer tax would be retained without change from present law.

XIX. MISCELLANEOUS PROVISIONS

A. The targeted jobs credit would be extended for 2 years, with the present rate for first-year employment and no credit for second-year employment.

B. Expired provisions for Vietnam MIAs and for expensing costs of removing barriers to the handicapped would be extended.

EFFECTIVE DATES

Effective dates generally would be January 1, 1987, for provisions for which the corresponding provision in the House bill is January 1, 1986.

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